

**ECONOMIC POLICY AND UNOFFICIAL ECONOMY IN TRANSITION:
THE CASE OF CROATIA**

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Summary

Research of the unofficial economy in Croatia has shown that the trends may have been influenced by both structural conditions (impoverishment, increased inequality, unemployment and lowering of the level of public services) and by institutional changes (privatisation, taxation policy and sanctioning). A special problem in Croatia's unofficial economy is its form in privatisation due to: a) the amount of social capital in the process of privatisation; b) the impossibility to measure the unofficial economy in privatisation; c) the attitude towards the revision of privatisation as a political and not an economic or legal question; d) the non-transparency of regulations and rules and the concentration of decision making powers in the hands of state officials (non-existent public control, appearance of state clientelism, etc.)

Inadequate penalties against those active in the unofficial economy in Croatia has resulted in public apathy and cynicism toward the legal functioning of the state and politicians. This will make efforts to control the unofficial economy more difficult.

Any economic policy directed towards prevention of the unofficial economy must: 1) reduce taxes and customs tariffs (as much as the state budget can take); 2) selectively reduce regulation; 3) reduce the role of the public sector (or the state) in the economy; 4) encourage evaluation of the share of the unofficial economy in the economy as a whole and in specific economic activities.

The following measures should be taken: 1) explanation, specification and co-ordination of respective laws and regulations; 2) strengthening of the independence and adequate organisational equipping of judicial system; 3) improving and better accessibility to statistics; 4) improvement in organisation, efficiency, professionalism and co-operation between government bodies; 5) reduction in the role the state plays in the economy, more rational spending of public money, better quality of service in the public sector; 6) reform of the pension system; 7) break with paternalistic capitalism; 8) control of privatisation completed so far and of privatisation of public companies; 9) strengthening of democratic control forms.

Preventing causes of the unofficial economy is far more important than punishing its consequences. The decisive role in this respect falls on the institutional sphere (the role of the state in the economy).

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The unofficial economy influences the successful implementation of the economic policy. The greater the unofficial economy is, the greater is its influence on the economic policy. Research has shown that the unofficial economy in Croatia has reached significant proportions - amounting to approximately 25 per cent of the GDP. This paper will therefore attempt to show the connection between the unofficial economy and economic policy, what stimulates growth of the unofficial economy and what measures can be taken to influence the way it develops.

Economic policy

The main goals of a country's economic policy are economic development and growth and as equal distribution as possible. Modern economic policies try to follow Samuel Johnson's principle stating that 'decent provision for the poor is a true test of civilisation.' People wish to improve their standard of living and the state must provide them with the best conditions to promote growth and the development of well-being both for individuals and for the state as a whole. Moreover, all people should have equal chances to enjoy that progress. Income redistribution is a rather dangerous matter. If it is too extensive and uses too weak tools, it may result in its own opposite. In other words, it may slow down the desired growth and development, without any significant improvements in distribution. Unequal distribution may also create political instability, which, too, is harmful to economic growth. In order to achieve steady growth and development, it is necessary to have a stable and long term economic policy.

Economic policy is based on economic analysis, but it also depends on the ethical and political attitudes prevailing in a certain society. Economic policymakers are influenced by

¹ This paper is derived from the project on the unofficial economy in Croatia conducted by the Institute of Public Finance in Zagreb for the Croatian Ministry of Finance. The project team report was finalised in early 1997 and it includes some 15 papers which can be obtained both in Croatian ("Financijska praksa", vol. 21, No. 1-2, June 1997) and English (<http://www.ijf.hr/finpraksa/eng/97/1-2/index.htm>).

various attitudes towards the relationship between individuals and the state. In modern societies, especially in the Anglo-American world, ever since the time of Adam Smith, the prevailing attitude has been that the state exists in order to help, promote and further the goals of individuals. The key questions posed by such an approach to the state and its role are how to determine the good of an individual and how to promote it. In addition, there is the eternal conflict of interest between the state and individuals and the question of how active a state has or needs to be.

The effects of economic policy are difficult to determine because it is impossible to perform controlled experiments. It is possible to bring together certain factors, which may influence a certain kind of behaviour, but it is impossible to foresee which of them will ultimately prevail. All economists can do is to try to estimate the direction and volume of change. (For more details see Rosen, 1996).

The poorer the country is, the greater is the imperative for it to take care of its economic policy. Rich countries can afford to lose resources, but poor countries cannot (Dornbusch, 1993). Rich countries can, at least for a short while, ignore their savings and investments, but poor countries cannot. A good economic policy is essential for the development of a country and its successful economic growth.

In modern economics, prevailing attitudes are mostly those of experts (Barro, 1994; Giovanni, 1993; Stiglitz in Giovanni, 1993, etc.) who claim that economic growth is influenced positively by the initial quantity of human capital in the form of education and health achieved, negatively by the relationship between government expenditures in the GDP and negatively by the measure of market disorder and political instability. It is most important that there should not be any great oscillations and that growth is steady in a large run even at lower rates. Economic policy measures which will be beneficial to the growth rate include: state protection of ownership rights and enforcement of contracts, maintenance of a free market and as small expenditure for non-productive consumption as possible, maintenance of a high level of human capital (in the form of education and health care and a low population growth), stimulation of greater, preferably private, investment in infra-structure (transport and communications), prevention of corruption and locally organised criminal activities. In other words, it is fashionable to claim that a good economic policy is that which stimulates privatisation and deregulation and a bad economic policy is that which disturbs market activities and does not protect ownership rights.

The state must not manage the economy, but can provide certain incentives. However, even these incentives are not completely innocent because it may lead to corruption, law

avoidance and the like. In this situation, it is essential to have public control mechanisms of state policy, which will prevent misuse of state protection and incentives. Moreover, the duration of a certain policy measures must be clearly defined in advance.

Connections Between the Unofficial Economy and Economic Policy

Experts from many areas are interested in studying the unofficial economy. They can be classified into several groups: (a) liberals, who are interested in the problems of poverty; (b) economic planners, who want the systems of their accounts to better represent the real economy; (c) radicals, who want to introduce a more structuralistic view of the economy into their planning analysis and (d) privatisation supporters, who can be either populists or conservatives (Peattieu, 1987). This is a very mixed and heterogeneous company and their motives often result in overstressing the significance of individual aspects.

The unofficial economy as a category in national accounts is in principle very attractive, but its scope is limited. As it is difficult to define the unofficial economy in the first place, it is equally difficult to measure it in the real world where collecting of relevant data takes place. To define the unofficial economy as non-regular, unregistered activities in the economy will place the whole concept rather out of the reach of measurement. Fiscal and monetary variables are crude instruments even in developed economies. This calls for special care in reaching conclusions.

The influence that the unofficial economy has on the economy as a whole is manifold. It influences (a) measurement of macroeconomic variables; (b) decision making in economic policy; (c) the efficiency with which the whole economy operates (Tanzi, 1980).

The unofficial economy is influenced by various factors such as taxation, regulations, restrictions, bribery of public servants, etc. (Tanzi, 1983). If the state dislikes the existence of the unofficial economy and it wishes to reduce it, economic policy must be directed against the factors mentioned. According to Tanzi, who obviously is not bothered by the issues of democracy, civil society, transparency, etc., this simply means the following: decrease in regulations, diminishing public sector, lowering taxation. Decrease in regulations, public sector and taxation are by their nature characteristics of positive economic policy and therefore also the direction and goal towards which the state should aspire. From the purely economic point of view, the achieving of these goals also provides hope for reducing the unofficial economy.

In order to check the extent to which this is possible, we need to analyse one factor at a time:

- a) Lowering taxes and customs tariffs is possible only as long as the state budget can take it. Tax rate is not the only important element here, but the quality of service given by the state also counts. The state must spend its budget rationally, guarantee just distribution, improve tax administration and severely punish tax evasion. When we speak of the unofficial economy in countries with a modern taxation system, the most interesting taxes are income tax, value added tax and contributions to social insurance. In countries in transition, the emphasis falls on the consolidation of the taxation system and tax administration.
- b) Deregulation can be achieved only by a selective approach. Certain types of regulations (regulation of labour market, monopolies, pollution, etc., are positive results of modern societies and no great decrease is possible here. It would be difficult to justify restricting regulations referring to minimal wages, overtime work, under-age work, work of foreign citizens, retired persons, pregnant women etc. This area calls rather for income taxation and social insurance contributions than for decreasing the regulation of the labour market. Developed countries have just started considering a decrease in regulation of the markets of goods, domestic financial markets and foreign exchange markets. Some of these regulations, however, have only just been introduced in countries in transition.
- c) In some areas curtailing restrictions is generally impossible or very hard to achieve (drugs, prostitution, illegal gambling) and, regardless of any amount of decrease, still leaves possibilities open for the development of the unofficial economy. In this situation, any regulation coming via economic policy is less important than efficient police control and protection.
- d) Decreasing bribery of public servants is also hard to achieve if their wages are small and state services users depend too much on their good will. Countries in this situation need to try to find a way out in restricting the importance of the public sector, or the importance of the state in the economy and in privatisation of the public sector, economic liberalisation, etc.

Considering the situation in modern countries, we might conclude that economic policies regarded in this light are in a no-way-out position. Most states spend too much and, bearing in mind the requirements that they face, this trend seems impossible to reverse. High state expenses result in high taxation and strong regulation, which in turn causes an increase of the unofficial economy. In this respect, countries can be classified into those where the unofficial economy is just a side effect of the official economy and those where

the unofficial economy is really large. Naturally, state policy cannot be the same in both cases.

Special attention should be paid to the direction of economic policy. If economic policy is only concerned with the official economy, it can control neither the positive nor the negative effects of the unofficial economy. Economic policy should therefore be interested in defining the share of the unofficial economy in the economy as a whole, as well as in individual activities. This is the only way in which those activities can be defined where official statistics are less reliable and where they do not offer a solid basis for economic analysis and economic policy management (Mikuljánek and Mažarevič 1997).

The Influence of Economic Policy on the Unofficial Economy

In order to determine the economic policy suitable to regulation of the unofficial economy, we should first learn the share of the unofficial economy and its importance for the economy in general. Kesner-Škreb (1997) emphasises that a state which wants to reduce its unofficial economy can do the following:

- a) in short term reference: to increase supervision, control and punishments, which would increase the risk associated with the unofficial economy and stimulate its transition into the official economy;
- b) in long term reference: to prevent factors which lie at the root of the unofficial economy (too high taxes and contributions, too strict and extensive regulations, etc.);
- c) stimulate economic growth and market transparency, reduce restrictions connected with entering the market, reduce the role the state plays, stimulate the growth of firms and companies, which will cumulatively contribute to the indirect reduction of the unofficial economy;
- d) encourage moral conduct and create a climate of public opinion against cheating the state. All in all, however, the most certain way to increase tax morale is rational behaviour in the spending of the state budget as the best way to show people that their taxes are wisely and efficiently spent and that they can expect a high quality public service in return.

State measures will depend on the size of the unofficial economy which is socially acceptable. Some countries are willing to tolerate a large unofficial economy in certain political and social moments in order to preserve social peace and vice versa. If they want to reduce the unofficial economy, however, they will implement a healthy fiscal policy, which will reduce tax burdens and increase the efficiency and control over financial expenditures, thus further stimulating the growth of competitiveness and transparency and

the growth in the size of firms and companies. It should, however, be concluded that the unofficial economy is inherent to all countries and only its size differs (Kesner-Škreb, 1997).

The Influence of the Unofficial Economy on Economic Policy

Not knowing the size of the unofficial economy makes successful implementation of the economic policy very difficult. The larger the unofficial economy is, the greater its influence on the wrong implementation of the economic policy will be. The unofficial economy distorts macroeconomic indicators in the following ways:

- a) If the growth of the unofficial economy is faster than registered, growth rates are shown lower than that they really are. Led to believe that it is in the midst of recession, the state may unnecessarily start running an expansionist policy (reducing interest rates and taxes, increasing state expenditures in order to stimulate growth, etc.)
- b) Underestimation of the GDP brings into question correctness of all relative indicators, which are derived from it. The gross domestic product per capita seems lower than it really is, while the share of taxes, government expenditures, imports, exports, etc. in the GDP seems higher. This may result in the fact that the economic policymakers may deceive themselves and/or the public by presenting the kind of information, which best suits, their needs at a certain moment. This is extremely dangerous because half-truths can be used to manipulate the public.
- c) The official unemployment rate can be overestimated due to the fact that workers in the unofficial economy are treated as unemployed, which can also lead the state towards running an unnecessary expansionist policy.
- d) Monetary policy may be more restrictive than is really needed.
- e) Lower prices in the grey market cause the rate of real inflation to be lower than the official figures show. But, in a situation of controlled prices in official markets and the lack of goods there, demand moves into the unofficial market, causing the prices to increase. Official statistics therefore show a smaller price increase than really exists in the grey market due to high prices there (Kesner-Škreb, 1997 and Tanzi 1983).

The Role of the Government in the Unofficial Economy

Relevant literature quite often offers various theories according to which a free society must significantly reduce and simplify the part the government plays in the economy. This

is, of course, hard to accomplish because nowadays pressure on the state budget is becoming stronger and stronger in all countries. In the most developed countries this is caused by the large number of people of advanced age, which results in an increase of costs for pension and health insurance. In countries in transition, these expenses are added the burden of transition costs and, in the case of Croatia, of the war as well.

Theoretically, we can assume that citizens will support a taxation system which results in amassing the financial means needed for service offered by the state. People are willing to make a fair deal: tax obligations in exchange for the benefit of receiving public services. The unknown element here is whether all of them really believe that they receive fair value for the taxes they pay.

From the macroeconomic point of view, we can talk about a tolerable or critical level of public expenditures. This level is understood to be the level above which any additional expense might be harmful to the success of the national economy and which could prevent its growth. It is frequently said that the elements, which influence the unofficial economy, are various government shortcomings causing increase in public expenditure. The most important of these are: poor legislation, cumbersome administration, incompetence and inefficiency of public workers, unpopular government which wastes national wealth, government with which most tax payers cannot identify, government insensitive to social circumstances, and government which spends too much and believes that it can do anything and knows everything (for more detail see Bawly, 1982).

Jeffrey Owens, the head of the OECD Fiscal Department, (Owens and Whitehouse, 1996) points out that one of the main problems of modern taxation systems is their complexity. Taxpayers have a hard time trying to understand the taxation system and tax administrators have a hard time in implementing it. All this results in increasingly complex and sophisticated tax evasion, more expensive collecting of tax income for the state and more expensive tax compliance for the tax payers. On the other hand, the increasingly sophisticated tax evasion backfires in causing taxation systems to become more complex because more detailed legislation is needed to fill in the holes in existing laws. In Great Britain, for example, total administrative and compliance cost of taxation is estimated to be 1.5 per cent of the GDP (Sanford, 1995). Two thirds of this amount refers to tax compliance costs.

American tax laws increased 200 per cent in the period between the 1950's to 1990's (Owens and Whitehouse, 1996). Approximately 90 million tax payers filed their tax return in the USA in 1979, which is a very impressive figure when compared with the 84 million who voted in 1980 (Bawly. 1982). In addition, tax laws become more and more complex.

No ordinary citizen can find his way around them, and even tax experts are faced with many difficulties.

In Canada, tax law grew three times over between the 1970's to 1990's and in the Netherlands it doubled. France is the only OECD country where tax legislation in the 1990's is the same as it was in the 1960's. Australia, New Zealand and Ireland have already started implementing programmes to improve tax laws with the purpose of reducing tax compliance costs.

There are other elements evident in the OECD countries, such as an increase of the tax burden from 25 percent in 1965 to almost 40 percent in 1994, broadening the tax base, increase of social insurance contributions, etc. (Owens and Whitehouse, 1996). All these are factors which will continue to influence a part of the economy to resort to operating in an unofficial form.

Besides deliberate resistance to tax paying, according to the 1995 Cato Institute report, of about 40 million Americans who were involved in 'direct conflict' with tax administration, most of them were simply confused by the complexity of the tax returns (** 1996). Some, of course, resent tax paying as a matter of principle, wishing to reduce the role of the government. People sharing this attitude even organised themselves as a political party of tax payers in the USA and came very close to nominating a famous right-orientated Republican Pat Buchanan as their Presidential candidate in the elections. In their opinion, the state is oppressive and tyrannical and they specially resent alcohol and tobacco taxes.

In a word, the tendency of laws and regulations in modern societies to expand repels citizens from the state and turns them towards the unofficial economy.

Some of the results obtained from the unofficial economy research in Croatia also seem to indicate that the state itself can influence the trends and changes the unofficial economy undergoes. Franièeviaè (1997) thus points out that the state can influence the unofficial economy directly if government officials involve in it, or indirectly if the state shows potential participants the desirability and/or feasibility of such unofficial activities. Some more recent trends seem to indicate the wish of the Croatian state to be big, expensive and paternalistic (which is very evident from the growing number of people who depend on the state: the greater part the state plays in infra-structure investments, expensive rescues of firms and banks, investment in status symbols of the state and government officials and inefficiency and legal and illegal extravagance). If such trends are allowed to continue, neither attempts at reducing the tax burden, nor public debt growth will be able to help. Tax evasion will not decrease, which will in turn be met by stricter controls and repressive machinery and the unofficial economy will continue to exist alongside the official one. If economic growth is stimulated by state investments and/or

subventions, it may present new possibilities for corruption and illegal pursuits. Heavy state participation in large projects intended as a substitute for unrealised private investments will warn tax payers that a possible fiscal crisis is at hand, especially if the expected high economic growth is not realised. A 'big state' means an increase of taxes and other burdens and provides strong motivation for tax evasion to continue. A wasteful and corrupt state, nepotism and inexpertise will only cause the unofficial economy to grow. Without significant preventive activities taken against these elements, the unofficial economy may well be expected to continue, especially if associated with the political aspects of social life. (For more detail see Franièevia 1997, and Kesner-Škreb, 1997).

Causes of the Unofficial Economy

In badly organised countries, in countries in transformation phases with an ineffective infra-structure, inadequately trained personnel and insufficient control techniques and sources, or in countries where government officials only take advantage of the possibilities offered by the unofficial economy (through, for example, forms of corruption such as blackmail, bribery or personal access to the unofficial economy by which they compensate for their apparent or seemingly low wages), the activities of state officials are much more often a factor influencing the unofficial economy than is usually thought (Clark, 1988). All of these elements can be found in Croatia, especially in the first years after it gained independence.

Štulhofer (1997) explains the process taking place in countries in transition. After the initial exhilaration caused by the fall of communism (and, in the case of Croatia, also by its break with Yugoslavia), a discrepancy develops between subjective expectations (high aspirations) and objective reality. This can be seen in: (a) impoverishment, with the unofficial economy representing a means of survival, social peace and maintaining own standard of living; (b) increased inequality and the gap between the new entrepreneur elite and the rest of the population, with the unofficial economy being a way of becoming rich overnight; (c) unemployment, meaning that without significant economic growth, the pressure of the unemployed leads to spread of the unofficial economy and (d) reducing the level of public services, which, together with discontent with these services (such as health care and pensions) stimulate tax and contribution evasion.

Transition means institutional changes which also contribute to development of the unofficial economy, such as privatisation, taxation policy and sanctions. In Croatia privatisation best illustrates the area where the 'strategies for side-stepping barriers' are seen best (Èuèekovia 1997), or, in other words, these areas where a way can be found to become an owner or a stock-holder without sufficient capital of one's own. The main

difficulty here is the fact that the unofficial economy in such cases is almost impossible to measure. Some specific problems are: (a) the question of privatisation revision regarded as a political, and not an economic, legal or moral problem; (b) non-transparency and concentration of decision-making power in the hands of state officials, which results in the absence of public control, the appearance of state clientelism and favouring politically determined and often regionally characterised networks of acquaintances. In a word, confidence in state institutions is destroyed and breaking rules and norms is justified.

The findings of Štulhofer's research (1997) are also interesting because they show a high level of opportunism in Croatia (higher than such level in Slovakia and Hungary, higher even than the level of opportunism in Romania). More than two thirds of examinees were convinced that the majority of public officials was involved in corruption. Most sensitive is the attitude that law avoidance seems to be considered smart and not a criminal activity and that tax evasion puts a perpetrator high on the social scale instead bringing him down. This seems to indicate that not even actual shameful exposure of tax avoiders would produce much result. Perhaps some results might be achieved by appropriate exposure of the really biggest offenders from the very top political circles. It might indeed be the only way of regaining confidence in institutions and their (politically) impartial control. It would also help to outline more precisely the lines of criminal activities in everyday's perception. Discovery, exposure and appropriate punishment, on the other hand, must not be politically motivated because this would only be perceived as political cleansing in the eyes of the public and would not change the current attitude towards criminal behaviour. Indeed, it might only contribute to an increase of public apathy.

In spite of political rhetoric in which transitional difficulties are primarily attributed to inherited socio-cultural habits, the collectivist inheritance of the socialist planning system is *not* the most important cause of today's relatively widespread opportunism and distrust in Croatia. It would most probably be more correct to consider opportunism and distrust in Croatia as a reflection of increased uncertainty (due to the introduction of market competition), a consequence of deep disappointment because of unfulfilled expectations after the breakdown of the planning system and an awareness of political patronage of privatisation and uneasiness resulting from all that.

Awareness of a just legal system, satisfaction with the way high government officials perform their job (directed towards achieving of the general good and not towards their own prosperity) and perception of the extent of corruption in state institutions have proved to be very significant factors. It is also very significant that the data show opportunism and distrust to be more frequent in larger, urban and socially and culturally more developed surroundings with easier access to information and a higher average level of information, etc. The fact that opportunism and distrust in institutions are more pronounced in young

than in older examinees is another cause for alarm because it opens the possibility of 'natural' reproduction of the unofficial economy and seems to indicate its (possible) long term durability.

The results of a survey of Croatian judicial statistics are alarming. The expenses linked to breaking rules that regulate economic activities are extremely low. The total number of persons legally persecuted is negligibly small and the number of those actually convicted is even smaller. The perpetrators are exposed to very low risk, since the courts of law are overloaded, employees too busy and court decisions take years to become effective. The direct result of this situation is the generally low number of charges actually pursued (Skorupan, 1997).

Research on the unofficial economy based on various approaches and performed in various methods shows a number of possible causes for the unofficial economy in Croatia. The causes are numerous. Sometimes they are even contradictory. Further research should, therefore, concentrate on linking specific causes and trends in the unofficial economy. Certain assumptions concerning the factors which cause it can, however, be listed as follows:

1. The assumption of some authors is that the growth of the unofficial economy in the economy as a whole (measured by the system of national accounts) up to 1993 may have been influenced by the decrease of real incomes, high inflation, the existence of parallel means of payment in domestic transactions, the high tax burden and the war. The decrease of the unofficial economy after 1993 might be influenced by sales, income and profit tax relief (Madžarević and Mikulić 1997).
2. Regarding the growth of the unofficial economy in industry, agriculture and trade up to 1993, it is assumed that the decisive factors were inadequate and insufficient financial control (the war, establishing of the new state which has yet to develop its own institutions), drop in production and real incomes (when people turn to the informal trade sector), transition reasons (cut in the number of employees in the formal sector accompanying privatisation and restructuring processes) and search for alternative and cheaper supply sources. The decrease of the unofficial economy in 1994 could have been caused by the development of financial control, decrease in taxation rates, restructuring of big retail chains, real income increase, etc. The unexpected renewed growth of the unofficial economy in 1995, in spite of financial control and further growth of real incomes, could be explained by a high rate of personal consumption, cheaper goods from imports compared with goods produced in Croatia, structural changes in consumption and a stronger demand for durable goods (Mikulić and Madžarević 1997).

3. The unofficial economy in international exchange could be explained by the same reasons and causes which are also found in other countries in transition (slow economic growth, high unemployment rates, high marginal tax rates and high level of public consumption). In Croatia, however, the following factors are especially apparent: inefficiency in the process of privatisation, non-existent industrial policy, problems associated with the economy of scale, shortcomings in the legal system (the adjustment of the legal system to the market economy not yet completed) and lack of robust penalties aimed at preventing illegal activities (Reljac, 1997).
4. The following causes may account for the role of the unofficial economy in privatisation:
 - a) the concept of privatisation chosen which has produced unfavourable consequences due to privileged sale (centralisation on the level of state administration of all decisions concerning ownership transformation and privatisation; transfer of a significant part of social-owned capital into state-owned property; choosing important buyers on the basis of political loyalty);
 - b) concentration of decisions concerning ownership transformation in the hands of a central state agency which is also in charge of the implementation of the process, a fact that further influenced corruption and similar activities;
 - c) the original legislative decision in which many important practical questions were left undefined, unregulated and unsolved, thus being left to be solved in practice (the Ownership Transformation Law, for example, has undergone six amendments);
 - d) non-existence of an appropriate information system of privatisation monitoring in the first years of ownership transformation;
 - e) the impossibility of broader social and political control over state institutions which are under the direct control of the ruling party (Éuèkoviæ 1997).

Besides these factors, the unofficial economy during privatisation process was also affected by the following:

- a) the war;
- b) the inheritance of managerial self-governing socialism (a delay in the privatisation of the banking system made possible the unexpected success of the old management profession in privatisation, but also the consolidation of the elements of the old bank manager structure);
- c) the political designs of Croatian capitalism allowed the ruling party to play a role in meriocratic privatisation, political choice of owners and open nepotism, which all

resulted in the unofficial economy and unofficial politics living side by side and of politics outside constitutionally based institutional control (Franièeviæ 1997).

5. The unofficial economy is certainly also influenced by the weaknesses of the Croatian post-socialistic state, such as the non-professionalism and incompetence of public workers and government officials, corruption, favouritism, overloaded administrative, inspection and especially the judicial system, etc. (Franièeviæ 1997).
6. Another specific feature is the large number of small firms and companies which are more inclined to operate in the unofficial economy and which mostly belong to the economic branches which themselves have tendencies towards the unofficial economy (such as trade, financial and other services and construction). It is interesting that a large number of informal activities are performed by economic entities which are part of the official economy. The reason for this can be found in the liberal regime and in low costs of registering companies from the period between the Yugoslav Enterprises Act to the Croatian Companies Act of 1996 (Franièeviæ 1997).

Some Suggestions for Economic Policy Measures Regarding the Unofficial Economy in Croatia

The unofficial economy is not an issue which can be considered on its own. It is difficult to define and, consequently, to speak about in precise terms. Experts engaged in research on the unofficial economy often have to conclude their research without any useful or usable results. It is imperative, therefore, always to be clear on the aim and purpose we wish to achieve, to clearly define the problem and then to proceed to develop the research, collect data and, based on them, reach conclusions and propose measures.

The state will have to keep solving the problems of the unofficial economy for a long time yet to come. Special accent will have to be put on: (a) discovering and including economic wealth and changes generated by those actively engaged in the unofficial economy and (b) defining and characterising such activities as criminal and not legitimate. As the state administration attempts to increase its control and draw funds from an increasingly broader range of activities (private, public, legal, quasi-legal, tolerable and criminal), more attention will have to be paid to the problems mentioned (Clark, 1988).

Two questions must be answered first: 1) with which visible elements is the unofficial economy most associated? and 2) who is really interested in defining the unofficial economy? If the problem is defined as:

- a) Tax evasion -- the Ministry of Finance (or Tax Administration) is most interested and the data on tax evasion, possibilities on improving the taxation system and tax administration should be collected and particular measures should be proposed.
- b) Unemployment -- the Ministry of Labour and Social Welfare is interested in order to examine possibilities of reducing unemployment benefits and the Ministry of the Economy and the Government are interested in order to stimulate economic growth. Data on the employed and unemployed population should be collected, measures for increasing employment and control of unemployment benefits determined, etc.
- c) Economic growth rate -- the Government is interested, and it calls for organisation of state statistics to monitor and measure growth and propose ways to stimulate it on the basis of relevant data, etc.
- d) Black marketeering -- the Ministry of Finance and the Ministry of the Economy are interested. It would be necessary to determine the data on prices of goods and services in Croatia and neighbouring countries, to find out where the discrepancies come from and to eliminate negative elements discovered (such as, for example, taxes, customs duties, inefficiency, rebates), etc.
- e) Unauthorised foreign exchange trade -- The National Bank of Croatia is interested and the foreign exchange rate should be re-examined.

In a word, one-aspect only research is not enough to prevent or eliminate the unofficial economy. It cannot provide usable results immediately. Several continuous lines of research are needed, intended for various users and with various purposes, which would use standardised data and overlap in many segments.

Individual studies of other colleagues researching the unofficial economy in Croatia describe in detail the problems of particular forms in which the unofficial economy appears and measures needed for their prevention. Some of them will be mentioned here:

- 1) Economic policy measures seeking to reduce the unofficial economy should place primary interest on the institutional sphere. In order to better understand the unofficial economy in Croatia, it is essential to understand the relation of the state towards the economy and toward society as a whole. It will not suffice to examine only the motives of private persons (entrepreneurs, employers, workers, consumers, etc.), but also the institutions of the economy and society, i.e. the state as a whole, needs to be examined, or the problem and nature of political sources and the motives and behaviour of politicians and administrators. The border line between the official and the unofficial economy in Croatia is not a problem only because the activities of the official and unofficial economy are closely connected and because the very

development of privatisation and market transformation influences the demand for (de)regulation, but also, because on top of all this, the state itself shows a tendency to operate in the grey zone (of politics, laws and the economy) (Franièeviæ 1997).

- 2) The state must see that the following goals are realised: a) high professional level of state services; b) complete independence and better organisation and equipping of the judicial system and the exclusive accountability to Parliament of highly professional control and inspection services (independent of the government); c) transparency of rules and regulations and of all procedures where the possibility of rent seeking is a stimulation to the unofficial economy; d) possibility of truly democratic and public control by citizens and their representatives over all state institutions; e) rational state expenses in spending public revenue, but also reduction of over extensive public expenditure (the share of public expenditure in the GDP); f) high quality service from the public sector; g) decisive break with paternalistic capitalism; h) equal conditions for small firms and companies in the capital market so they do not have to look for capital in the grey market (Franièeviæ 1997).
- 3) When it comes to reducing the unofficial economy in a particular area, such as foreign trade, the following elements are essential: improvement in the customs services and implementation of techniques for improving trade statistics, cost analysis and, consequently, analysis of the price of goods and services, followed by prevention of misinvoicing, etc. It is also essential to undertake the necessary changes in the legal system (eliminate some of the more important shortcomings in laws and introduce stricter sanctions for illegal economic activities in international exchange), to improve official statistics and the efficiency and co-operation between the Customs Office, the Foreign Exchange Inspectorate and the National Bank of Croatia, as well as to constantly monitor trends in international exchange and the most recent systems for their monitoring (Rejjac, 1997).
- 4) Research on tax evasion indicates that the unofficial economy could probably be reduced by introduction of value added tax (return of prepaid tax introduces better compliance) and the reform of pension system (in the sense that a pension would depend on the amount beneficiaries were willing to pay). If the decrease of tax evasion in 1994 was really influenced by the improvement in tax administration, financial inspection and customs duty administration, their further improvement might be expected to continue exercising a positive effects. Of course, too great a role of the state might negatively influence unofficial economy reduction. When making decisions about measures, it is more important to prevent the causes of the unofficial economy than its negative consequences (penalties, introduction of new taxes, etc.) From the liberal point of view, the unofficial economy will decrease if economic growth,

stabilisation, privatisation and restructuring are realised and if the role of the state in the economy is reduced, if taxes are lowered and if the rights the unemployed enjoy are diminished (Madžareviæ 1997).

- 5) Measures should be taken to prevent the part played by the unofficial economy in privatisation by: a) the government, by relieving of duty officials responsible for such conduct (in Hungary, for example, when a high official in the Privatisation Agency took a bribe, the government changed the whole Administrative Council of the Agency as well the responsible Minister of Trade and Industry); b) the police, by efficient investigations when a criminal act is suspected; c) the judiciary, by quick and efficient decisions concerning the charges. Measures to control the unofficial economy in privatisation include: a) clearer and more precise laws which would prevent the state administration from making arbitrary decisions as they please and provide discretionary interpretations of the laws; b) political strength of state authorities to publicly condemn negative actions and an efficient judicial system; c) acceleration and completion of privatisation as soon as possible, which would prevent harmful long term consequences or risks of corruption, fraud, bribes, etc.; d) more detailed research on the unofficial economy in privatisation, which would first of all have to have open access to the data in appropriate state institutions (various ministries, funds and agencies). This is particularly important because privatisation of public companies has yet to be effected and in value they far surpass the value of capital which has already been privatised (Eùekoviæ 1997).

Suggestions for Further Research of the Unofficial Economy in Croatia

All research carried out so far indicate that continuous and co-ordinated research on the unofficial economy in Croatia and its position compared to the unofficial economy in other countries is necessary. Further research should include empirical, economic, social and political processes in Croatia. Research and insight into own reality will prevent the further practice of simple imitation (sometimes even enforced) of solutions reached by others.

- 1) Further sociological research should concentrate on: a) measurement of social transition changes and trends (the minimum being comparison of Croatian social structures of 1989 and 1995); b) measurement of law transparency (comparison with other countries, calculating the indices of complexity and incorporated control); c) measurement of judicial efficiency (comparison with other countries); d) measurement of the extent and focal points of corruption; e) socio-cultural analysis of tax evasion (and its comparison with the results of the Control Department of the Tax

Administration Office); f) measurement of public opinion concern the unofficial economy (a continuous monitoring of social confidence in legal institutions and desirability of the unofficial economy) (Štulhofer, 1997).

- 2) In order to gain better assessment of the unofficial economy in the system of national accounts (with probably a lower share after adjustment of statistical research), the following factors are essential: broader comprehensive and better quality research of individual values of the GDP (economic activity by entrepreneurs and agricultural workers, gross investments, international exchange flows statistics), application of the UN system of national accounts (SNA), regular surveys of personal consumption, calculation of the GDP according to the organisational principle, etc. (Madžareviæ and Mikuliæ 1997).
- 3) To measure the unofficial economy by a monetaristic approach it is necessary to: a) have a standard measure of the nominal GDP; b) pay more attention to foreign currency and include it into future research on analytical currency supply in the unofficial economy; c) research and monitoring the connection between seasonal trends and the unofficial economy in certain economic activities (such as, for example, tourism); d) monitor all data series required for the monetaristic assessment of the unofficial economy, which would make it possible to use this long term method in calculating the size of the unofficial economy, a procedure which is not yet feasible in Croatia (Jankov, 1977).
- 4) In order to determine the unofficial economy in particular economic activities it is necessary to: a) update and upgrade official statistics (adjust and co-ordinate them with international standards, monitor small firms and businesses in an appropriate way, use smaller and unbiased samples); b) make available official data on the GDP for every year; c) conduct a survey with the primary purpose of estimating the size of the unofficial economy; d) prepare an input-output table (the last such table was made for 1987 and enormous structural changes have occurred since then); e) statistically monitor trends of formal activities (Mikuliæ and Madžareviæ 1997).
- 5) In order to influence future trends and the success of privatisation, there should be a thorough study of proportions and effects the unofficial economy has had in the privatisation process so far. New research should be based on field research in a chosen sample of companies in which primary information would be collected and give more reliable indicators about the proportion of the unofficial economy in the process of ownership transformation and privatisation in Croatia. Special attention should be paid to: a) take-over and acquisition of privatised companies and the need for regulation; b) the development and regulation of investment funds as mediators in

massive privatisation; c) the experience of privatisation of public companies with the supervision of foreign supervisors; d) the experience of developed countries in the transfer of unofficial activities into the official economy (Èùèkoviæ 1977).

- 6) In order to improve understanding of one of the most extensive sources of entrepreneurship within the unofficial economy and to prevent economic and political one-sidedness, it is necessary to carry out fuller research on the economic, socio-cultural and anthropological characteristics of special communities (such as, for example, communities of Janjevo or Herzegovina), on the role of 'networks' in their businesses and on the levels and mechanisms of informality (Franièeviæ 1997).
- 7) Bearing in mind the special significance of small enterprises in the unofficial economy, their status in the Croatian taxation system should be given special attention. The two major questions are: Is it true that taxation system in Croatia works against small businesses because it stimulates capital investments and 'penalise' owners for employing more workers, thus pushing them towards tax evasion? Does the value added tax put a relatively greater burden on small enterprises? (Franièeviæ 1997)
- 8) The political economy of the unofficial economy in Croatia should also be studied with care in order to determine what kind of state Croatia is going to be (liberal, professional and competent, small, corporate, paternalistic, rife with corruption, nepotism and incompetence, big and expensive, etc.) It is only partially true that economic growth followed by an increase of wealth and real incomes in the official economy will by itself and on its own solve the problem of the unofficial economy. This is closely linked with the political, economic and socio-political characteristics of a state. Here the accent should be on the influence of the emerging regulatory regime, on its appearance, forms and level (Franièeviæ 1977).

Conclusion

Research on the unofficial economy both abroad and in Croatia indicates that we should be extremely sceptical about the prevailing opinion according to which high economic growth, economic liberalisation and reduction of state involvement in the economy will automatically reduce the unofficial economy. To a certain extent it really *is* true, but taken alone is neither enough, nor explanatory.

The effects of the unofficial economy are contradictory. Any conclusions should, therefore, be reached with utmost care, and with special attention paid to the fact that the unofficial economy might become a permanent feature of the Croatian economy and society. We should not be deceived by opinions that the unofficial economy is only a legacy from the past or the consequence of as yet incomplete transformation into the market economy.

Accelerated economic growth may be one of the ways to reduce the unofficial economy, but it may also be a new stimulant to unofficial economic growth due to new opportunities for the fast development of entrepreneurship resulting from such growth. However, if the real source of the unofficial economy is the state itself and the way it intervenes in the economy, the unofficial economy will certainly survive. But, as Franièeviaè (1997) points out, the legitimacy of capitalism can be established only by reliable and firm sanctions when the rules of the game are broken, and by increasing the reputation of law-makers and legal authority in general. This does not mean that political campaigns should be conducted which would produce no results, except to further decrease the reliability of the government and the introduction of arbitrary political decisions instead of the legal and proper functioning of the state bodies. A privatised market economy requires institutionalisation and penalties when the rules are broken. This will ultimately be the goal of the new entrepreneurs who have succeeded thanks to the unofficial economy. They will want to continue developing, protect themselves from new competition and improve their own standing. People who used to be 'financial engineers' yesterday are the owners of saving-banks today and will want to be bank owners tomorrow, all of which will require regulation, reputation, etc.

All countries have an unofficial economy, from the very richest to the extremely poor ones, the reasons for it may be similar or they may be different. Participants in the unofficial economy may be trinket sellers in the streets of Calcutta, members of the European aristocracy in luxurious villas in Monaco or Harvard graduate lawyers in a simple log house somewhere in the deep forests of Vermont. They are variously stimulated by hunger and the need to provide for their many children, by evasion of high margin tax rates or simply by the resentment they feel for the state and the material goods of modern civilisation.

Obviously, the unofficial economy is very widespread. In Croatia, considering the short term, it will be influenced by poverty, falling behind in development, etc. In the long term, it will be influenced by a post-materialistic trend present even in the most developed countries. In any case, it would be advisable to prepare for living with the unofficial economy, try to understand it as much as possible, measure it and manage it.

Nowadays, Croatia is somewhere in between. The war resulted in a large number of unemployed, impoverished and displaced persons, who were forced to black market food from neighbouring countries and to engage in working on the black market without paying taxes and contributions, in order to survive. While at the other end of the scale were the new entrepreneurs who employed people without registering them with the appropriate authorities, avoided paying taxes and contributions and regular registration in general. The children of this new, rich class have now begun to take over and will perhaps come to understand the benefits of post-materialism and hopefully break with the system of values their parents have.

All these represent potential participants in the unofficial economy and Croatia is now at a cross-road. Establishing a new state with new institutions after forcibly breaking with the former system of values, Croatia has two choices. There is a group of countries where the unofficial economy is only a side-effect of the official economy. The state monitors it, knows it, tolerates it and takes measure to control that part which is against its interests. There is another group of countries where the unofficial is the prevalent economy, along with a Mafia and all the corruption, lawlessness, anarchy and hopelessness which are bound to follow. It is up to the state, to the measures it will take within the bounds of its economic policy and within its constitutional, judicial and political norms and regulations, to decide which road it is going to take.

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